

# FUTURE OF REVENUE MANAGEMENT

## The future of pricing in services

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### INTRODUCTION

One goal of this paper is to develop a further understanding of both customer loyalty and the future of pricing. A related goal is to demonstrate how service firms need to think about their pricing strategies to achieve greater revenues and greater customer loyalty. In order to develop this understanding of loyalty and the future of pricing, the paper first examines the definition of customer loyalty more closely and provides a framework for thinking about loyalty. Next, the paper presents research that shows how revenue management, if practised indiscriminately, can destroy customer loyalty. Thirdly, the paper presents a

way of thinking about the history of pricing strategies — from *one price for all* to the current practice of *revenue management* and finally to the future of pricing — *value pricing*. Fourthly, the paper presents a way of thinking about *value*. Specifically, it shows that value is more than just the financial elements of the service. Finally, ways of changing the value perception in order to earn higher revenues are presented. This last section presents actual research showing that changes in the way prices are framed can increase revenue and loyalty.

### WHY LOYALTY IS IMPORTANT

Noone *et al.* (2003) articulated in this journal why customer loyalty is important. Citing Reinartz and Kumar (2002), they state 'it is a widely held belief that *loyal* customers are an organisation's most profitable customers, that they cost less to serve, are usually willing to pay more than other customers and often generate new business via word-of-mouth recommendations. These benefits are usually cited as foundations for pursuing customer loyalty initiatives'.

From a pricing perspective, it is important to understand more fully this notion of loyalty, as it will help pricing managers

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understand better the attitudes and behaviours of their best customers. This notion of loyalty is discussed next.

### WAYS OF THINKING ABOUT LOYALTY

In the academic literature, numerous ways of describing loyalty have been suggested. Some of the definitions refer to the emotional side and some strictly to the behavioural side of the customer. Others incorporate both. Shoemaker and Lewis (1999) illustrate the emotional side of loyalty when they state that loyalty occurs when 'the customer feels so strongly that you can best meet his or her relevant needs that your competition is virtually excluded from the consideration set and the customer buys almost exclusively from you — referring to you as their restaurant or their hotel'. Nagle and Holden (1995) also focus on the emotional side when they claim that loyal buyers 'value consistent product quality and performance and they rely on trusted suppliers to continue providing it. Their ongoing loyalty is driven fundamentally by the risk and uncertainty associated with untested suppliers'. This issue of trust is critical in terms of revenue management, as will be discussed later in this paper.

Monroe (1999) illustrates the behavioural side when he describes loyalty as customers 'selecting in' and 'selecting out' certain products over others.

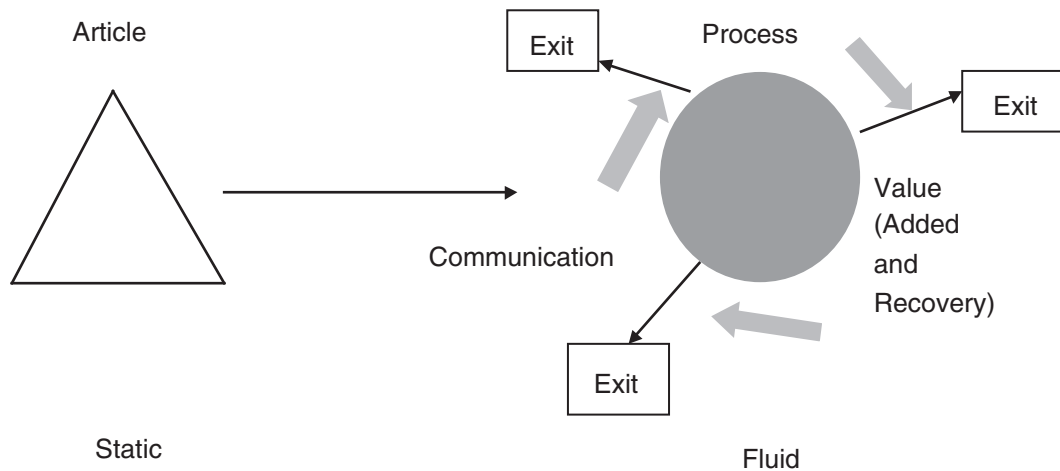
Reinartz and Kumar (2002) use a combination of both emotions and behaviours to describe loyalty when they categorise customers into four types: strangers, butterflies, barnacles and true friends. Strangers and butterflies are categorised as short-term customers, while barnacles and true friends are considered long-term/loyal customers. Barnacles exhibit behavioural loyalty, while true friends exhibit both behavioural and emotional loyalty. Strangers and butterflies exhibit no loyalty.

### CREATING LOYALTY: AN OVERVIEW OF THE COMPONENTS OF THE LOYALTY CIRCLE

Shoemaker and Lewis (1999) first discussed the process of creating loyalty as an equilateral triangle, where each leg of the triangle is involved with the process of creating and maintaining customer loyalty. This equilateral triangle functions as a design or blueprint for creating long-term loyalty only if each component of the triangle performs equally well. The Loyalty Triangle can also be viewed as a circle wherein it represents a continuous fluid cycle that creates and maintains customer loyalty. The Loyalty Triangle is now referred to as the Loyalty Circle. The components of the Loyalty Circle are shown in Figure 1. The reader will note that at each stage the customer can exit the relationship, thereby illustrating the fact that, unless all three components are performed well, loyalty will not exist. Although each component of the Loyalty Circle is briefly discussed, the critical part for pricing managers is the *value* component of the circle.

The first component of the Loyalty Circle is the *process*, which is 'how the service works'. It involves all activities from both the guest's and the service provider's perspectives. Ideally, there should be no gaps in this process. A gap occurs when the service interaction does not meet the needs of the guest or the service provider. For the guest, the process includes everything that happens from the time s/he begins buying the service (eg searching the Web for information) to the time that they leave the establishment (eg picking up their car from a valet.) All interactions with the firms' representatives are part of this process. For the service provider, the process includes the design of the service operations, the hiring and training of service personnel, and the collection of information in order to understand customers' needs, wants and expectations.

Figure 1: Creating loyalty



The second component of the Loyalty Circle involves the value creation activities that a company uses, namely the value-added and value-recovery activities. The purpose of employing value-added activities for the company is to increase the loyalty commitment of the guests. This is achieved by offering benefits that are deemed more advantageous to the repeat customer than to ordinary guests. Examples of value-added activities in the hotel business include room upgrades, fast check-in and guaranteed room availability. The other component of the value creation activity process is value recovery. Although companies would like to minimise service failures, there are times when value-recovery activities are needed in order to rectify any failures in the service delivery process. The purpose of this value-recovery process is to offer compensation to the guest in order to acknowledge the oversight of the company and to minimise any costs associated with this failure.

The last component of the Loyalty Circle is communication. This part of the circle involves all the different ways in which the organisation communicates directly with its customers. The communi-

cations should be customised in order that the message presented fits the needs, desires and behaviours of the customer. An example of a communication activity that can create loyalty is when a firm notifies its best customers about a potential sold-out situation and reminds these customers that, should they wish to purchase the service, they should make their reservation immediately. In their study of luxury hotel users, Bowen and Shoemaker (1998) found that such a communication strategy would definitely make customers more loyal.

As mentioned, the value-added activities are the component of the loyalty circle to which pricing managers should pay particular attention, because the future of pricing pertains to pricing for value received by the customer and not the costs incurred by the seller. Pricing managers need to consider this value, as it is a sure way to earn additional revenue. The components of value are discussed next.

#### THE VALUE ACTIVITIES: VALUE ADDED

Value is typically defined as the total savings and satisfaction that a customer receives from the product that they purchase (Nagle and Holden, 1995). Zeithaml (1988) postulated that, from the consumer's

view, value is defined as (1) low price, (2) when the customer receives what s/he expected to receive, and (3) when the product quality reflects the price that was paid. Dube and Shoemaker (1999) argue that there is more to value than low price. Specifically, they argue that there are six types of value one must consider: financial (eg saving money on future transactions, complete reimbursement if service failure, 10 per cent discount at gift shop); temporal (eg saving time by priority check-in); functional (eg check cashing, website available); experiential (eg upgrades or turndown services); emotional (eg more recognition and/or more pleasurable service experience); and/or social (eg interpersonal link with a service provider). In fact, the hotel companies Dube and Shoemaker (1999) studied had all developed strategies that presented a relatively broad portfolio of these various sources of value. Most of them had created for each member a preference profile that allows the hotel to 'customise' the stay for each guest, adding as much value as possible to each transaction as well as to the long-term relationship. Despite this promising start, however, the collected information was used to improve operations and create loyalty. It was not used either to improve pricing procedures or to justify the prices presented to the consumer.

The need to justify prices to the consumer is critical if one is to gain loyalty, as discussed next.

#### **HOW REVENUE MANAGEMENT DESTROYS CUSTOMER LOYALTY**

Although the practice of revenue management is such a significant element in the everyday operations of a service company, there is evidence that suggests, if it is used incorrectly, revenue management can have an adverse effect on guests' perceptions of the service company, thereby destroying customer loyalty.

Noone *et al.* (2003) argued in this journal that, from a hotel's perspective, it is critical to incorporate revenue management and relationship management. If one does not incorporate the two together, then loyalty will decrease.

Bowen and Shoemaker (1998) state that revenue management 'appears to be the type of opportunistic behaviour that can inhibit guests' trust and loyalty'. Furthermore, Bowen and Shoemaker (1998) suggest that yield management should be applied to customers whom the hotel views as not meeting the qualifications of a loyal customer.

In order to gain insight into reactive opportunistic behaviour, Bowen and Shoemaker presented a hypothetical situation where a hotel increased its rates temporarily because of anticipated demand. Specifically, respondents were presented with the following scenario:

'Assume that you go to make a reservation at the luxury hotel you claim you are loyal to and you find out that they are charging you \$100 per night more than they usually do because they have only a few rooms left'.

This situation was meant to simulate a situation where the hotel exhibited opportunistic behaviour by taking advantage of high occupancy. Respondents were asked a series of questions relating to this situation to see whether they would exhibit any reactive natural opportunistic behaviour. The findings indicate that respondents' behaviour would change if confronted with the above situation. Specifically:

- 49.9 per cent strongly disagreed (a rating of '1') with the statement 'my feelings toward the hotel would not change as a result of the above action'.
- 31.8 per cent strongly disagreed with the statement 'what I told others about the hotel would still continue to be positive'.

- 60.3 per cent strongly agreed (a rating of '7') with the statement 'the next time I made a reservation at this hotel, I would be more likely to ask about the rate'.
- 35.7 per cent strongly agreed with the statement 'the next time I came to this hotel I would check hotel rates at other properties'.

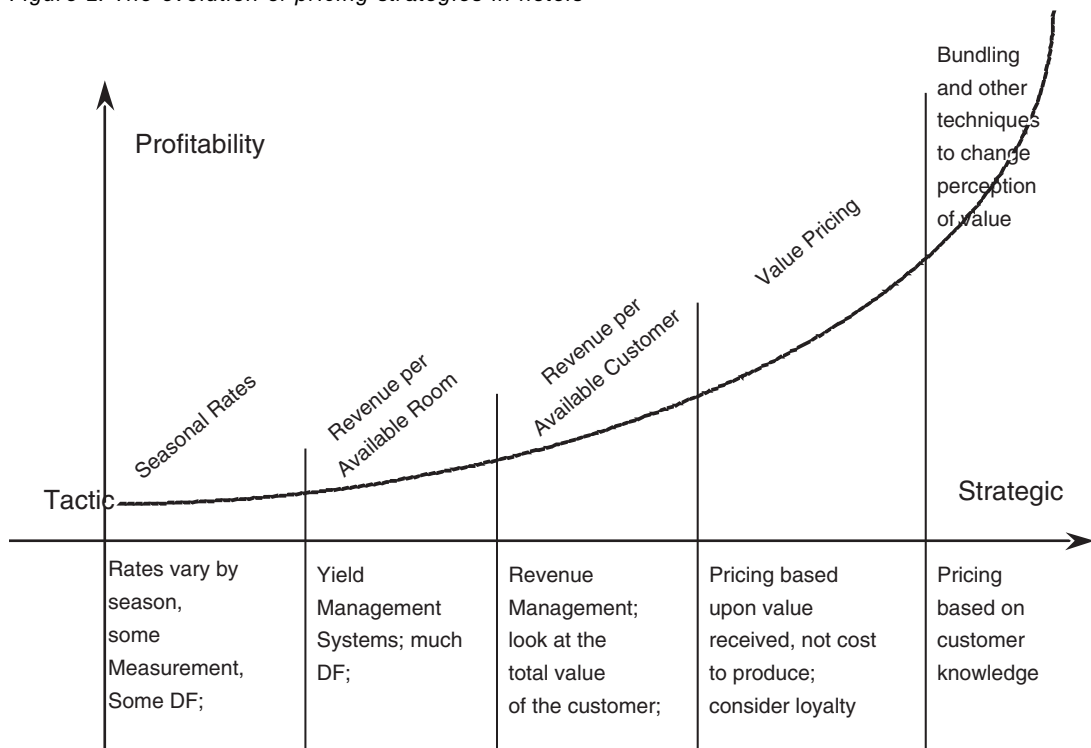
Given these results, it is clear that firms must carefully prove to their guests that the differences in room rates for various market segments are justified and reasonable.

Kimes (1989) also points out that yield management can turn out to be a tool that alienates the company's existing customer base. She argues that yield management may be most effective in the airline industry, where the small number of major competitors does not enable the customer to have much choice. The hotel industry, however, proves to be a different case,

because the hotel industry has many more competitors, and customers naturally have more options from which to choose. If yield management is not carefully justified here, customers, no matter how loyal to the company, can choose to stay with another competitor.

The findings of Bowen and Shoemaker (1998) and others present an interesting dilemma for those involved in pricing. On the one hand, revenue management has been extremely profitable in the short term but, on the other hand, clearly it has negative implications in the long term when it comes to creating customer loyalty. Yet, most business decisions are made for the short term. In order to understand how to respond to this dilemma, it is necessary to look at the past and future of pricing. The hotel industry is used as an example which provides a parable for other service industries.

Figure 2: The evolution of pricing strategies in hotels



## OVERVIEW OF THE HISTORY OF PRICING IN THE HOTEL BUSINESS

Figure 2 shows the past and future of pricing. It shows that, in the beginning, hospitality firms basically offered the same price for their products. Rates only changed by season, not day by day. Any demand forecasting that was undertaken was used by management not to set rates, but to determine the scheduling of employees.

The second phase of pricing occurred with the advent of yield management systems to the airline industry. The yield management systems designed for the airlines were then adapted to the hotel industry. Hoteliers used the information provided by the yield management systems to forecast demand and change prices accordingly. The standard statistic used to measure results was REVPAR, or revenue per available room.

Noone *et al.* (2003) presented the third and current phase of pricing in the hospitality industry. In this phase, revenue management and customer relationship management come together. Pricing managers not only consider demand in setting prices and availability, but they also consider the lifetime value of the customer buying the service. Harrah's Entertainment recently implemented a customised revenue management system which merges their traditional yield management system with their Total Rewards programme. Other firms are beginning to do the same. In this phase of pricing, the standard statistic used to measure results is REVPAAC, or revenue per available customer.

In this author's view, the fourth and next phase of pricing focuses on the value delivered to the customer, not necessarily the availability of inventory. Essentially, pricing managers will move from being controlled by their revenue management systems to having their systems as just one part of the overall marketing mix. In setting rates, pri-

cing managers will examine the different components of value being delivered and price accordingly. This way of thinking about pricing becomes critical in a down economy where there is a tendency in many firms to lower prices in order to fill capacity. The problem with lowering prices, of course, is that one destroys the brand image, and it also becomes hard to raise prices when demand improves. Here, high prices can occur even if demand is low. The statistic used to measure this will be VALUE-PAC, which is value generated by and for per available customer. The *value by* the customer is the price paid and the *value for* is the costs incurred by the firm supplying the value. The key, of course, is for the firm to supply features that the customer really values, but have little cost to the service firm. An upgrade on an aeroplane is but just one example. Last room availability is another.

Pricing will reach the final phase when the consumer is completely incorporated in the pricing decision. In other words, pricing managers will use knowledge of consumer behaviour to determine not only how to price, but how the pricing information is presented to the consumer. The measurement here will also be VALUEPAC. The VALUEPAC statistic will be higher in this phase than in the previous phases.

The theory for this final phase comes from economics and psychology. It is discussed next.

## HOW TO PRICE TO MAXIMISE REVENUE WHILE MAINTAINING LOYALTY: BEHAVIOURAL PRICING AND PROSPECT THEORY

The 2002 Nobel Prize in Economics was awarded to Daniel Kahneman, who currently teaches at Princeton University. Interestingly, Dr Kahneman is not an economist, but rather a psychologist who has spent his career studying how people make decisions under conditions of risk and

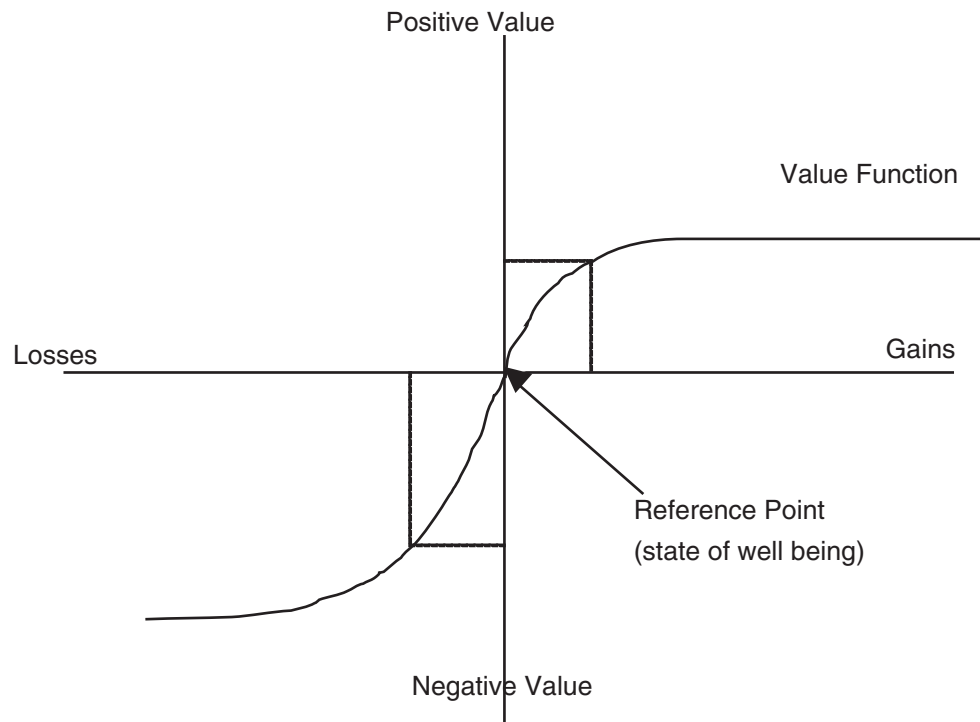
uncertainty. Unlike economists, who believe that consumers are consistent and rational in their decision making, Dr Kahneman and his long-time coauthor Dr Tversky showed that people are not consistent in their decision making. In fact, they found that they were quite irrational, and often this irrationality followed a pattern. (The Nobel Prize is not awarded posthumously, so Dr Tversky did not share the prize; however, the committee did recognise Dr Tversky.) Kahneman and Tversky published a paper that explained this systematic pattern in the economic journal *Econometrica* in 1979. They called their theory 'Prospect Theory'.

Prospect Theory (Kahneman and Tversky, 1979) argues that, when people make decisions, they do so by examining changes relative to a reference point. The area to the right of the reference point is called the 'gain domain', and the area to the left is called the 'loss domain'. Deci-

sions made when one is in the gain domain are different from those made when one is in the loss domain. Again, traditional economists argue that decisions should be consistent, regardless of the reference point. The gain and loss domain is represented by a line, which is called a value function. This value function is not straight; rather, it is shaped more like an 's'. Figure 3 shows the value function.

To examine the implications of the value function, consider gambling. Research has shown that when gamblers win, they become more conservative (ie risk averse); that is, they put money in their pocket to save their winnings. When gamblers are in the loss domain, however, they tend to take more risks; that is, they take money out of their pocket in order to win back their losses. Economists would argue that gamblers are either risk takers or risk averse, and their behaviour should be consistent if they are winning or losing.

Figure 3: Value function in Prospect Theory



The finding that the value function is 's' shaped, rather than straight, indicates that the incremental gains become less pleasurable and incremental losses become less painful. Returning to the gambling example, this suggests that people would be very excited with an initial gain of \$100, but less excited as they gained their second \$100. Similarly, the loss of the first \$100 would be extremely painful, but the loss of a second \$100 would be considered less painful than the initial \$100 loss. This explains why gamblers often 'chase their losses'.

The key to whether one is in the gain domain or the loss domain depends upon the reference point. This reference point is different from person to person. Kahneman and Tversky, however, found that the reference point could be changed, depending how the decision is presented or framed. For instance, consider the following two options presented to consumers who were interested in booking a hotel room in Las Vegas:

- *Option A:* Luxury suite room at \$159 and then for an additional \$30 you get a guaranteed room on a high floor with a strip view.
- *Option B:* Luxury suite room with a guaranteed room on a high floor for \$189, or room for \$30 less anywhere in the hotel.

In this example, Option A sets reference point at \$159 without a guaranteed room with a Las Vegas Strip view (a desirable trait) and then penalises buyers an additional \$30 if they want a guaranteed Las Vegas Strip view; that is, a loss relative to the reference point. This loss occurs in two places: the cash cost of \$30 and the lack of the Las Vegas Strip view. In contrast, Option B first establishes a reference point of \$189 with a guaranteed Las Vegas Strip view and then rewards buyers \$30 who do

not wish a Las Vegas Strip view; a gain relative to the reference point.

When the \$159 rate was quoted first, 13.6 per cent choose to pay an additional \$30 for the guaranteed Las Vegas Strip view, which means 86.4 per cent elected to keep the rate of \$159. When the \$189 rate was quoted first, 20.6 per cent elected to take this rate; the remaining 79.4 per cent decided to 'take a gain of \$30' and reduce their cost from \$189 to \$159. The additional revenue generated by the quoting of \$189 first was approximately \$31,000 per month, or approximately \$372,000 per year. (This true example comes from a major Las Vegas Resort Casino that wishes to remain anonymous.) Equally important to the additional revenue is that the customer feels better about the transaction. If s/he wants a guaranteed Las Vegas Strip view, s/he gets the room, if they do not want this type of room, then they receive a discount. The guest further feels that the hotel is looking after their best interest, thus building trust. As demonstrated by Bowen and Shoemaker (1998), trust is a major component of loyalty.

The implications of Prospect Theory for those who practise pricing in the services industry are tremendous. Space limitations prohibit discussing all the ways firms can use Prospect Theory to their advantage. Two immediate implications, however, are as follows. One implication is that firms should structure transactions to reflect gains and avoid losses. For instance, always show/quote the actual price, and then the discounted price. In high demand times, the rate will appear unchanged. In contrast, in low demand times should the price be reduced, the consumer will perceive himself/herself in the gain domain. Of course, the gain need not relate to financial gain. Any one of the value components discussed earlier can be manipulated to appear in the gain domain, regardless of the price. For instance,

National Car Rental ran an advertisement in the USA which argued that, by renting from National, one was able to save 45 minutes of time. The advertisement then asked the consumer to ask himself/herself: 'What would you do with this time?'. The implication, of course, is the extra time is always a gain, and that gain can be considered to have a reward — whether it be emotional (more time with friends and family) or financial (my time is worth \$100 per hour, as such I saved \$75).

A second implication of Prospect Theory is that once customers have agreed to spend a certain amount of money, getting them to spend more is much easier than one would think. This implies that it is much easier to sell additional services at the time of booking than when the customer is actually consuming the service. For example, consider a firm that sells a hotel room for \$140. If the firm wanted to sell a bundle of services for \$20 (eg free internet access, free local phone calls, etc.), the time to sell the bundle would be at the time of reservation when the 'loss' would go from \$140 to \$160. If the firm waits for the guest to show up at the hotel to sell the bundle, the 'loss' would now go from \$0 to \$20. Although the actual amount in both cases is still \$20, psychology the 'loss' seems great from \$0 to \$20 than it does from \$140 to \$160. Again, the shape of the value function that is exhibited in Figure 3 illustrates this.

## SUMMARY

As service businesses become more competitive and as these businesses begin to realise the importance of customer loyalty, they must begin to think about new ways of both pricing their services and presenting these prices to consumers. The goal is to have the customer believe that the firm is truly looking after his or her best interest. This belief will yield additional revenue to the firm and will also create additional cus-

tomers loyalty. As stated throughout the paper, the customer will provide value to the firm, and the firm will provide value for the customer.

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